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Economic Conditions
Governmental Finance
United States Securities

New York, August, 1942

General Business Conditions

THE decision of the War Labor Board awarding a wage increase to the "Little Steel" workers, and establishing principles to govern future wage changes, has overshadowed other developments in the domestic situation during July. The wage increase already is spreading to other steel companies, and the formula on which it was based will allow advances in other industries. Thus the first effect of the decision — apart from its bearing on future wage stabilization — is to yield more ground to the inflationary influences.

At the same time, the farm bloc in Congress has moved again for higher farm prices. Early in the month the Senate passed, and the House Committee on Agriculture later approved, a bill to make government loans on six staple farm crops at full parity prices, instead of 85 per cent of parity as required by the present law.

The stability of commodity prices since the General Maximum Price Regulation was issued has been a gratifying feature of the business news. It has reestablished orderly markets, allayed panicky stocking of goods, and held the cost of living steady, which provides a base for stabilization of other elements in the inflation spiral. However, there is no assurance of continuing stability unless public policy deals effectively with the causes of price advances as well as with prices. Both the wage increases and the parity loan proposal add to the danger of a fresh spiral. If parity loans are adopted, the effect in raising prices will be direct and immediate. Higher wages will raise costs, and as they spread to companies whose operating margins are already being squeezed by price ceilings they will intensify pressure to puncture the ceilings.

Even where the wage increases are borne chiefly by the United States Treasury, either because the Government buys at higher prices or because the added expense to corporations is largely offset by reduction in their income and excess profits taxes, they are none the less inflationary in character. They give the workers more money to spend, at a time when there are fewer goods to buy. They cut Treasury revenue, since workers are lightly taxed compared with corporations, and increase the deficit and borrowings.

Principles of the Wage Award

Since the President's message to Congress on April 27, the country has been waiting for a determination of wage policy and a definition of the "stabilization" to which the Administration is committed. The Board included in the "Little Steel" decision a strong statement of the need to prevent the cost of living from spiraling upward because of wage adjustments, and with that purpose adopted a formula including five principles. The first four, which are those applying to future wage demands, are as follows:

(1) For the period from Jan. 1, 1941, to May, 1942, which followed a long period of relative stability, the cost of living increased by about 15 per cent. If any group of workers averaged less than a 15 per cent increase in hourly wage rates during or immediately preceding or following this period their established peacetime standards have been broken. If any group of workers averaged a 15 per cent wage increase or more, their established peacetime standards have been preserved.

(2) Any claim for wage adjustments for the groups whose peacetime standards have been preserved can only be considered in terms of the inequalities or of the sub-standard conditions specifically referred to in the President's message of April 27, 1942.

(3) Those groups whose peacetime standards have been broken are entitled to have these standards re-established as a stabilization factor.

(4) The board, as directed by the President in his April 27 message, will continue to "give due consideration to inequalities and the elimination of sub-standards of living."

These principles may be reduced to a statement that wage workers are entitled to retain their peacetime standards of purchasing power, that such standards are those prevailing on January 1, 1941, and that adjustments of inequalities and elimination of sub-standards of living will go on. Mr. William H. Davis, Chairman of the Board, expressed his conviction that these yardsticks "lead to a terminal for the tragic race between wages and prices."

The Real Standard of Living

The "established peacetime standards" of many millions of people have already been reduced by the war. These include the men in the armed forces, the white collar and professional workers, unorganized labor, pensioners, small business men, and all others whose taxes and living costs have risen more than their income. The first comment of these groups on the above principles is likely to be that industrial workers cannot preserve "established peacetime standards" except at everyone else's expense.

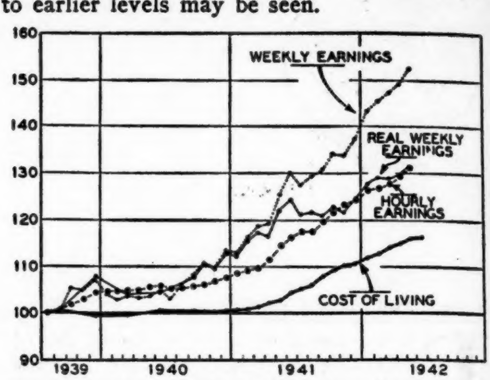
Unquestionably this is true. The real standard of living is in the production of goods and services, and when there is not enough to go around no group of the population can have what it has been accustomed to without leaving less for other groups. If all groups try to obtain more through increased money income, the purchasing power of money will diminish.

The War Labor Board recognized, again in the words of Mr. Davis, that "to win the war all of our citizens * * * will be called upon to restrain their purchases and surrender many things they have become accustomed to." However, the Board did not feel called upon to take this into account in formulating its principles. Mr. Davis stated that the sacrifice to pay for the war falls upon the country as a whole and that it should be apportioned "not in wage determinations by the War Labor Board addressed to workers alone, but in taxation by Congress."

This statement is in accord with the truth that responsibility for the fight on inflation falls on the Government and the Administration as a whole. As a practical matter, however, wage earners are in a preferred position. Factory payrolls through May had increased 60 per cent since January 1941; they are still rising steadily, and the aggregate increase since the beginning of the war has been 111 per cent. From the viewpoint of avoiding inflation, neither present taxes nor those included in the new bill as passed by the House make more than a small dent on this swollen purchasing power.

The Definition of "Peacetime Standards"

If the Board had selected an earlier date than January 1, 1941 as the measure of peacetime standards its formula would have been different. According to the indexes of the Bureau of Labor Statistics of the U. S. Department of Labor, hourly wage rates in January 1941 were 9 per cent higher than in August 1939, weekly earnings were 13 per cent higher, and "real wages", which are weekly earnings adjusted for changes in cost of living, were 12 per cent higher. The course of hourly and weekly earnings, the cost of living, and real weekly earnings since the war broke out is diagramed in the accompanying chart, from which the relation of January 1941 wage rates to earlier levels may be seen.



Earnings and Cost of Living of Labor in Manufacturing Industries. Aug. 1939 = 100. Source: Bureau of Labor Statistics.

In May 1942 hourly earnings were 31 per cent higher than in August 1939, weekly earnings were 53 per cent higher, and, after allowance for a 16 per cent increase in the cost of living, real weekly earnings were 32 per cent higher. Comparison of the May figures with August 1939 rather than with January 1941 would have led the Board to conclusions of quite different practical effect, for over the longer period there would be few if any industrial workers whose hourly wage has not outrun, and substantially, the rise in living costs.

It is also informative to compare wage rates with those of 1929, for the figures are illuminating as to the extent of the long-term improvement in factory workers' standards of living. According to indexes compiled by the National Industrial Conference Board, hourly earnings at the beginning of 1941 were 29 per cent higher than the average of 1929, weekly earnings were 7 per cent higher, and due to a lower cost of living the real wage was 25 per cent higher. By May of this year, hourly earnings were 53 per cent higher, weekly earnings 36 per cent higher, and the real wage 40 per cent higher.

These figures show that the stand taken by the Board promises to all labor, assuming continuation of present working hours, a minimum real wage 12 per cent above that prevailing before the war and 25 per cent above that of 1929; while in many cases, as shown by the May 1942 averages, real wages are substantially above that level.

The Question of Future Wage Stabilization

To sum up the practical effects of the decision, the fact that it represents a partial retreat before the attack of the inflationary elements is evident, and is pointed out in a separate concurring opinion of the employer members of the Board. The task now is to hold the

new position, and the question is whether, if living costs continue to rise, further advances in money wages will be allowed. The governing principle of the decision, that wage rates should be raised in proportion to rises in living costs, establishes a "parity" objective for labor, similar to that established for the farmer by law. The pursuit of parity, however, perpetuates the inflationary spiral, for an advance in prices or money income of one group tends to push up the prices or money income of the others. The paramount consideration of the present time, recognized in the introductory quotation from Mr. Davis given above, is to interrupt this spiral.

The import of the second of the principles laid down is that rises in living costs after May 1942 will not be considered a basis for wage advances as long as January 1941 standards are not broken. The converse of this, however, seems to be that workers who up to now have been below the January 1941 standard, and who will now attain it, will be entitled to increases sufficient to hold it if living costs go up. No explicit statement of policy as affecting workers whose standards are much above January 1941 is made.

Another uncertainty relates to the probable application of the principle of giving "due consideration to inequalities and the elimination of sub-standards of living." This is a phrase which may be interpreted either narrowly or broadly, and if the latter, possibly to the extent of weakening the whole stabilization effort.

Since developments are unforeseeable, and largely out of its own control, the Board doubtless considered it impracticable to tie its hands. It is charged with responsibility for but one of the seven points in the President's anti-inflationary program, which must rely for success not upon stabilization of any single element in the wage and price spiral, but upon effective integration of the policies of Congress and of all the agencies concerned, each supporting the other. Nevertheless, the whole program will be no more effective than any of its parts; all must stand firm, and the policies of the agency charged with the stabilization of wages are, to a great extent, controlling.

Another aspect of the decision, important for the post-war situation, is the inclusion of adjustment for the cost of living in the regular wage, rather than as a separate bonus. This detracts gravely from the flexibility of the wage structure; for as a rule wages raised in boom periods have been rigid, if not frozen, in subsequent depressions, and have been an obstacle to the reductions in cost needed to promote recovery. A separate bonus, on the other hand, automatically is reduced and finally disappears as the cost of living comes down. This system is employed in the Canadian wage control, which froze wage rates as of November 15, 1941, but provided for a bonus of 25 cents weekly, or one per cent of the basic wage if less than $25 a week, for each one point rise in the cost of living index. The allowance thus is the same for all workers receiving the base wage or higher, and the contribution to the inflation spiral is held to a minimum.

The Farm Bloc Moves

The bill to establish loans on the basic farm crops at the full parity price, which has been referred to briefly, is awaiting action in the House. When it will be called up, if at all, is not yet clear. On July 15 the House finally acceded to the Senate proposal to permit the sale of 125,000,000 bushels of government-owned wheat for livestock feed and industrial uses at 85 per cent of the parity price of corn, or about 83¢ a bushel. If loans on wheat at 100 per cent of parity should now be established the Government would be lending $1.34 per bushel to the wheat grower, and at the same time selling wheat at 83¢.

The purpose of the sale of wheat below the market price is to provide an ample supply of cheap feed in order to stimulate production of meat, dairy and poultry products. Thus the policy is anti-inflationary in intent. On the other hand, the projected loss of 51¢ per bushel, if the parity loans are adopted, will add to the Treasury deficit and put the money in the hands of the wheat growers, available for spending. This is an illustration of the contradictions that exist in anti-inflationary policy when complicated by the demands of pressure groups.

Other situations are arising which increase the call for subsidies. Because the March ceiling prices would not cover the increased costs of producing the 1942 packs of canned, dried and frozen fruits, Mr. Henderson has permitted the first important puncturing of the retail price ceilings; but if similar situations rise in the future he has stated that he prefers to pay subsidies, and is seeking an appropriation. Secretary Wickard has a subsidy program for the small pork packers, to prevent them from being forced out of business by their present unprofitable operating margins.

The disposition to rely upon subsidies, of which more undoubtedly will be heard, is disquieting. They conceal inflation, reducing the price indexes to meaningless figures. In some cases they may be less costly to the public than general price increases, but for the most part they merely transfer costs from consumers directly to all the people, with the cost of administration added. They open the gates to abuses. If widespread they may be placed according to political expediency, and where that is done their effect often is to maintain production which is not needed or is inefficient

and which may divert productive energies from places more useful in the war effort.

Many present economic policies undoubtedly would be different if all groups of the people realized that war is not a condition of prosperity, in which they may aspire to a greater share. On the contrary, war in its effect on living standards is a state of depression, however the fact may be obscured to the general view by high industrial activity, high payrolls and farm income, and the other recognized business indexes. There is no "melon" of increased production of goods and services to be cut; instead the supply of the necessities and comforts of life to be divided is smaller. Pressure group demands are in general demands for a slice of a non-existent melon; and when they are based on the principle of "equality of sacrifice" they pervert a noble phrase. Whether through misunderstanding of economic principles, or through intent, they are in fact attempts to avoid sacrifice, by laying the burden on the other fellow.

Money and Banking

With money in circulation and bank deposits steadily rising under the influence of wartime industrial and credit requirements, the banking situation is undergoing a transformation no less radical than that experienced by industry. Just as by the Summer of 1941 the enormous demands of the war had taken up most of the slack in the industrial system and created a problem of under—rather than over—capacity, so these demands are now eating rapidly into the huge backlog of idle funds in the banking system. The problem is no longer one of dealing with too much funds in the market, but rather of seeing to it that there are enough funds for carrying out the gigantic task now lying ahead.

The credit situation, in short, has reached the end of an unusual and distinctive period. For nearly a decade prior to 1941 funds were tending to accumulate in the banks in excess of available outlets. Except for the brief interlude when reserve requirements were increased in 1936 and 1937, excess reserves were steadily rising and the banking business had become accustomed to conducting its operations on a "cushion" of excess reserves so large that adjustments of position of individual institutions seldom involved more than adding to, or subtracting from, reserve totals already well in excess of the needs.

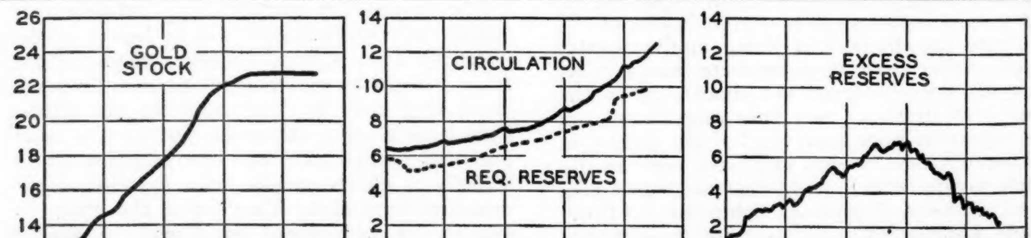
The cause of this great increase in excess reserves was mainly the huge imports of gold that followed the devaluation of the dollar early in 1934. So long as gold imports were increasing bank reserves at a rapid rate, while currency and credit were expanding at a lesser rate, excess reserves of course continued to rise.

In 1941, however, the situation underwent a radical change, as shown in the diagram below. Not only was there a tapering off and eventual cessation of gold imports, but demands for currency and credit began to reflect the rising tempo of the war production program. With the money market thus squeezed from both sides, excess reserves, after reaching a peak around $7 billions in the latter part of 1940, began to decline; they continued downward in 1941 and 1942, with a particularly sharp drop in the Fall of last year due to the increase in reserve requirements effective November 1.

Altogether, within the space of about a year and a half, approximately two-thirds of the maximum accumulation of excess reserves was wiped out, and the current total of somewhat over $2 billions would be still lower but for the substantial additions to money market funds recently effected through Federal Reserve open market operations. With the factors that have contributed to the decline thus far still at work, the question of how much lower excess reserves will fall depends upon the policy of the monetary authorities in making funds available to the market.

Position of the New York Market

In dealing with the broad problem of maintaining adequate funds in the banking system to support war financing, it may be noted that the problem centers in the New York money market. As the central money market of the country, it is essential to orderly financing

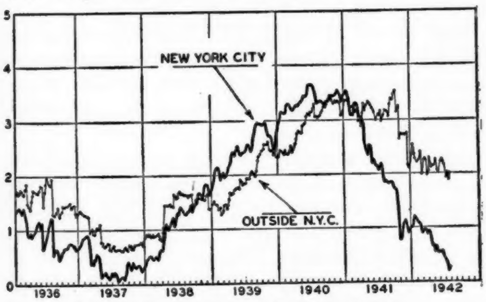


Principal Factors Affecting Excess Reserves—Monetary Gold Stocks, Money in Circulation, Member Banks Required Reserves Against Deposits and Excess Reserves. (In Billions of Dollars)

at stable rates that this market be kept in liquid condition and able to function in an effective manner. Yet it is precisely at this point that the impact of the war financing program has been the heaviest. Of the decline of nearly $5 billions in excess reserves of all member banks from the peak, over $3 billions has taken place at New York.

The reason for this is to be found mainly, as often pointed out, in the rising activity of the war industries in the interior. Not only is a substantial portion of the funds raised in New York by taxation and borrowing transferred directly by the Treasury to make payments to contractors in other districts, but likewise a good portion of the money spent here goes to head offices of contractors whose plants and workshops are in other districts and where the money is needed locally to meet payroll and other accounts. Moreover, the increase in reserve requirements last Fall resulted in the withdrawal of considerable out-of-town bank money on deposit with correspondents here, to meet higher reserve requirements at home.

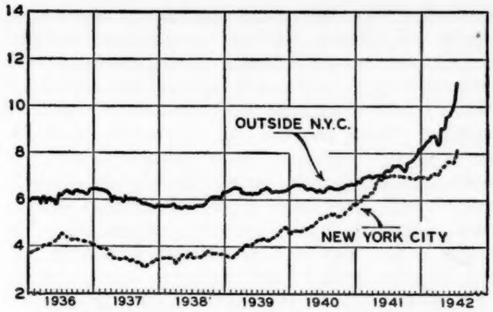
As a result, New York bank reserves have been subjected to a continuous drain, indicated by the following diagram comparing the movement of excess reserves of New York member banks with those of member banks for the rest of the country. Whereas excess reserves in New York City have lost approximately nine-tenths of their previous rise, those for the remainder of the country taken together are down by less than half; and even a good part of this can be attributed to the increase in reserve requirements last Fall.



Excess Reserves of Member Banks
(In Billions of Dollars)

The manner in which these movements of funds, in turn, have influenced the government security holdings of banks in New York City and "outside" is indicated in the next diagram covering figures of the weekly reporting member banks.

In the years 1939, 1940, and first half of 1941, New York City banks accounted for most of the increase in bank holdings of government securities. As the rise of their excess reserves was halted and followed by a pronounced decline, their increase in investments was also checked, although they continued to subscribe to a share of all new issues. At the same time the banks outside of New York, which had been gaining funds and whose excess reserves in consequence had been relatively well maintained, were able to increase their rate of purchases.



Government Security Holdings of Weekly Reporting Member Banks (In Billions of Dollars)

Within the last few months, however, the rise in security holdings of New York banks has been resumed, notwithstanding a further decline in their excess reserves to new low levels since 1937. While the greatly increased total of Treasury issues offered to the market during this period has been a factor in this increase, other factors have been the increased supply of short-term readily marketable Treasury bills and certificates, increased confidence on the part of the financial community that adequate reserve funds will be available to carry out the financing in an orderly manner and at relatively stable rates, and recognition on the part of banks of the need of giving support to the Treasury program through fuller investment of reserves.

Of the increase of over $1.3 billion in government security holdings of the New York banks since February, holdings of bills and certificates have contributed $770 millions, Treasury bonds $760 millions, and notes $170 millions, while holdings of guaranteed issues have declined $400 millions by reason of refinancing.

Recent Steps in Credit Policy

The foregoing account of money market changes indicates the financing problem. Briefly stated, this is, first, to provide adequate funds to the banks to enable them to take their share of the new financing coming along, without at the same time flooding the market with excess reserves and driving bond prices higher and interest rates lower; and, second, to adapt the types of securities offered to the needs of the market.

In furtherance of these objectives, the following steps have been taken:

1. *Increase in Treasury bills and certificates:* As the volume of surplus funds is reduced,

banks find themselves in increasing need of a supply of prime, highly liquid investments that can be converted into cash promptly and without loss in the event of clearing house or other debits requiring adjustment of reserve position. With the decline in recent years in outstanding brokers' loans, bankers' acceptances and commercial paper, the supply of such investments has been greatly reduced while bank deposits have greatly expanded. Although this was not a serious handicap so long as the banks held cash far in excess of their needs, it is a different matter when banks are operating on close margins of excess reserves; and it has tended to prevent the banks from making as full use of their funds as would otherwise be the case.

With a view to relieving this starvation of the short-term market and increasing the facilities for reserve adjustments between banks, the Treasury has increased its weekly bill issues from $150 millions to $350 millions and has reintroduced the short-term Treasury certificate, of which approximately $3.1 billions have been sold in the past four months.

2. *Open market operations:* By announcing in April a policy of buying all Treasury bills offered at 3/8 per cent, the Reserve Banks have given assurance to investors that bills are practically the equivalent of cash, while at the same time providing an automatic method of adjusting reserve funds to the needs of the market. Since this policy was announced, over $500 millions of additional reserve funds have been put into the market through purchase of bills by the Reserve Banks.

In addition to bills, the Reserve Banks have bought over $300 millions of other government securities, providing support in special market situations as well as increasing the total of bank reserves. Altogether, as a result of recent purchases, total Federal Reserve holdings of government securities have risen to a new high record above $3.1 billions.

3. *New legislation:* Passage by Congress of legislation, sponsored by the Reserve Board and approved by the Treasury, authorizing the Reserve Board to reduce reserve requirements in the central reserve cities of New York and Chicago, without necessarily changing requirements in the rest of the country. With the shortage of reserve funds mainly in the financial centers, the effect of this legislation is to give new powers to the Reserve System to relieve points of pressure, without at the same time adding to the volume of reserve funds at points adequately supplied.

Thus step by step a program is being worked out through the joint efforts of the Treasury, the Reserve Banks and the banking community for dealing with the money market problems incident to the financing of the war deficit. As the outlines of this program have become clearer, and investors have gained assurance in the huge borrowing requirements of the Government being met without any serious mechanical difficulties, they have been enabled to proceed more confidently in subscribing to new Treasury offerings.

The real danger in the huge borrowing program is not that there will be difficulty in selling the bonds, but rather in the effect of a great expansion of bank credit upon the economy of the country. Because of the inflationary threat in such an increase in purchasing power, every effort is needed to cut down the dependence upon bank credit and increase the proportion of securities bought and paid for out of the current income of the people.

The Half Year's Earnings

The decline in corporation earnings which appeared in the first quarter of this year continued in the second quarter; and the half year's earnings of industrial companies which have reported during the past month show, in a great majority of cases, a considerable decrease in net income, compared with a year ago. Sales as a rule were substantially larger, but operating expenses were higher and taxes took a greatly increased percentage of income.

A tabulation of the statements of 290 companies in the major manufacturing, mining, trade and service industries shows for the first half of 1942 combined net income of approximately $475 millions after taxes, which compares with $725 millions for the same companies in the first half of 1941, — a decrease of 35 per cent.

This group of companies, representative for the most part of the larger organizations, employed an aggregate capital and surplus of approximately $12,600 millions at the beginning of the year.

Reserves for federal income and excess profits taxes reported by 155 of the manufacturing companies were up sharply from last year because of the steep increase in rates proposed in the pending revenue bill, which almost all of the companies used as a basis for their computations. For this group giving tax details, the estimated tax liability for the first half year 1942 amounted to $884 millions, compared with $578 millions in the corresponding period of 1941 and $163 millions in 1940. Such taxes absorbed 73 per cent of the net income before taxes this year, compared with 52 per cent in 1941 and 27 per cent in 1940.

The portion of industrial corporation income being taken by federal taxes is now far above that ever reached in the past. During the last war, federal taxes absorbed only about 23 per cent of the net income of all manufacturing corporations in 1917, 45 per cent in 1918, and 26 per cent in 1919.

Separate quarterly figures available for 252 of the industrial companies indicate that net income after taxes in the first quarter of 1942 was 29 per cent below that of the first quarter 1941, while the second quarter 1942 was 41 per cent below the second quarter 1941. One of the principal reasons for the greater drop was the fact that second quarter earnings this year in many cases were burdened with charges for additional tax reserves covering the first quarter. These additional reserves were necessitated by the fact that the provision originally made is now found inadequate in view of the revenue bill as recently passed by the House.

The pending rates of 90 per cent on "excess profits" above the "base" as defined, plus 45 per cent combined normal and surtax, compare with maximum rates of 87½ and 45 per cent respectively when the bill was reported to the House, and with 94 per cent (including 14 per cent post-war credit) and 40 per cent originally decided on in the House Ways and Means Committee. The corresponding rates effective in 1941 were 60 and 31 per cent, in 1940 were 50 and 24 per cent, and in 1939 there was an 18 per cent normal tax only.

Other Factors in Lower Income

In addition to the sharply increased taxes, other important factors in the lag of net income this year have been the cost of conversion to war production, the lower earnings on war orders as compared with civilian goods, and adverse conditions that have developed in numerous industries as a result of the war. These are reflected in our accompanying summary by major industrial groups.

Many corporate reports have commented on the narrowing of profit margins as a result of increased labor and other operating costs, with selling prices limited by price ceilings. Restrictions upon sales have curtailed the earnings of companies distributing coffee, tea, sugar products and many other foods. Petroleum refiners have been hit by rationing as well as by sharply increased transportation costs.

Higher railroad freight rates have raised costs throughout industry, while motor trucking and delivery costs have also risen. Priorities have practically driven out of business large numbers of concerns which formerly used critical materials.

Reduction and Omission of Dividends

The squeeze in net income after taxes, together with absorption of cash by higher inventories and receivables, and by expanded plant and equipment, have caused widespread reduction and omission of dividends during each month since the first of this year. Between December 31, 1941, and June 30, 1942, the average annual rate of dividend being paid by industrial common stocks declined from $2.09 to $1.76 per share, according to Moody's index.

NET INCOME OF LEADING CORPORATIONS FOR THE HALF YEAR

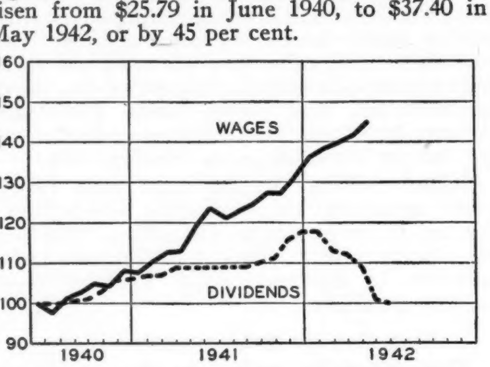
Net Income is Shown After Depreciation, Interest, Taxes, and Other Charges and Reserves, but Before Dividends—Net Worth Includes Book Value of Outstanding Preferred and Common Stock and Surplus Account at Beginning of Each Year.

(In Thousands of Dollars)

No.	Industrial Groups	Net Income Half Year 1941	Net Income Half Year 1942	Per Cent Change	Net Worth January 1 1941	Net Worth January 1 1942	Annual Rate of Return % 1941	Annual Rate of Return % 1942
4	Baking	$6,197	$6,240	+ 0.7	$187,742	$182,264	6.6	6.8
18	Other food and beverage	39,212	30,853	— 21.3	576,462	583,143	13.6	10.6
15	Textiles and apparel	12,327	8,669	— 29.7	182,033	196,704	13.5	8.8
13	Paper products	7,134	6,564	— 8.0	175,275	181,616	8.1	7.2
25	Chemicals, drugs, etc.	93,342	67,035	— 28.2	1,349,393	1,423,458	13.8	9.4
9	Petroleum products	106,673	64,739	— 39.3	2,200,176	2,224,059	9.7	5.8
8	Stone, clay and glass	12,370	5,099	— 58.8	193,468	189,503	12.8	5.4
26	Iron and steel	145,274	86,233	— 40.6	2,968,108	3,093,872	9.8	5.6
8	Building equipment	7,669	6,055	— 21.0	185,330	186,612	8.3	6.5
10	Electrical equipment	43,514	32,022	— 26.4	572,330	632,045	15.2	10.1
22	Machinery	19,624	16,401	— 16.4	269,528	293,077	14.6	11.2
7	Office equipment	12,215	9,124	— 25.3	156,221	162,383	15.6	11.2
7	Automobiles	124,574	51,146	— 58.9	1,177,340	1,210,647	21.2	8.4
14	Auto equipment	11,753	10,178	— 13.4	114,590	128,462	20.5	15.8
9	Railway equipment	10,619	8,062	— 24.1	176,848	190,221	12.0	8.5
24	Metal products—misc.	16,404	13,434	— 18.1	261,489	276,457	12.5	9.7
23	Misc. manufacturing	19,625	14,245	— 27.4	403,509	422,113	9.7	6.7
242	Total manufacturing	688,526	436,099	— 36.7	11,149,842	11,576,636	12.4	7.5
11	Coal mining	2,735*	4,110*	+ 50.3	212,286	217,542	2.6	3.8
6	Metal mining	7,648*	9,093*	+ 18.9	162,445	161,501	9.4	11.3
10	Mining, quarrying—misc.	10,855*	11,139*	+ 2.6	172,786	181,096	12.6	12.3
14	Trade (whol. and retail)	8,197	6,918	— 15.6	269,899	270,306	6.1	5.1
7	Service and construction	7,290	7,224	— 0.9	214,459	219,433	6.8	6.6
290	Total	$725,251	$474,583	— 34.6	$12,181,717	$12,626,514	11.9	7.5

* Before certain charges.

Dividend rates have now fallen below the level of June 1940, when the enlarged national defense program was begun. This trend is in contrast—as shown in the accompanying diagram—with that of average weekly wages paid in the manufacturing industries, which according to the Bureau of Labor Statistics have risen from $25.79 in June 1940, to $37.40 in May 1942, or by 45 per cent.



Average weekly earnings in the manufacturing industries (U. S. Bureau of Labor Statistics) and average annual dividend rate on industrial common stocks (Moody's Investors Service). June 1940=100.

Even the record high rates of taxes on corporate income do not tell the whole story of the loss to shareholders, inasmuch as whatever remains of corporate income is taxed a second time when received by individuals, at rates running up to 88 per cent in the top brackets. Multiple taxation at such extreme rates reduces the net dividend yield to large shareholders to the vanishing point. Also, taxation of corporate profits at rates which force omission of dividends falls inequitably upon several million smaller shareholders, because it taxes this portion of their income at rates far above their regular bracket. Thus a shareholder with a net taxable income of $5,000, under current proposals, will pay 11.4 per cent in income taxes, a rate proportioned, in theory at least, to his ability to pay. But where his dividends are omitted or reduced in order to pay taxes, that part of his income is taxed much more heavily. Non-profit organizations, educational and religious trusts, etc., pay no income taxes, and their loss of income due to this cause is an indirect levy upon them at a very heavy rate.

New Records in Railroad Operation

Total operating revenues of all class 1 railway systems for the half year are estimated at around $3,300 millions, which is 36 per cent above the same period of 1941 and 8 per cent above the former peak in 1929. Both net operating income, and net income after interest charges, increased from last year but were below 1929, because of the rise in operating expenses and taxes. Net income after taxes for the half year is estimated at around $275 millions for all class 1 systems, which compares with $170 millions last year and represents an annual rate of return of 5.1 per cent on the aggregate capital stock and surplus.

This encouraging showing, after long years of lean earnings, reflects the new high records established during the period in volume of freight traffic, and the speed and efficiency with which it has been handled. Heavier and more careful loading of cars has greatly increased the effectiveness of existing facilities. For example, in May, according to Joseph B. Eastman, Director of Defense Transportation, the average load of less-than-carload merchandise was 17,858 pounds per car, in contrast with an average of 10,600 pounds per car in May 1941. This and similar gains in operating efficiency not only improve railway earnings statements, but have been of incalculable benefit to the war effort.

A feature somewhat modifying the earnings showing is that expenses for maintenance of way and equipment would in many cases have been considerably larger, and net income correspondingly smaller, except for inability to obtain the needed steel and other materials. This deferred maintenance will in most instances have to be made later on, and constitutes an increasingly serious difficulty in the present period of abnormally heavy traffic demands.

Utility Gross Income Up, Net Down

Production of electric power during the first half year continued to soar to new high levels, and the operating revenues of 25 leading systems increased 5 per cent over the first half of last year. Because of the rise in operating expenses and taxes, however, net income for the half year declined by 24 per cent. The following table summarizes the results:

Gross and Net Earnings of 25 Leading Public Utility Systems for the Half Year
(In Thousands of Dollars)

Operating revenues	1941	1942	% Change
First quarter	$191,566	$204,349	+ 7
Second quarter	176,359	183,783	+ 4
Half year	367,925	388,132	+ 5
Net income after taxes			
First quarter	35,287	29,083	—18
Second quarter	23,508	15,541	—34
Half year	58,795	44,624	—24

The decrease in net earnings of operating companies has caused an even sharper drop in the net income, after payment of bond interest and preferred dividends, available on the common stock of some of the large public utility holding companies. Market prices for sixteen such issues averaged only $4 per share at the end of July 1942, compared with $11 at the end of June 1940.

The Need for Post-War Reserves

The earnings reported in the foregoing article are at variance with the popular idea that the corporations are profiting hugely from the war, and the figures supply reason for the great concern with which corporation executives view the rapid increase in federal taxes. The dangers were dealt with effectively in a letter which Mr. A. W. Robertson, Chairman of the Westinghouse Electric & Manufacturing Company, addressed in June to members of Congress. With reference to the April income figures of his company showing a return of slightly over 2 per cent on sales, and less than half the net income in the same month a year earlier, Mr. Robertson said:

> This is not enough profit to pay even modest dividends to stockholders and continue reasonable wages to employes, without considering the well-recognized necessity to make some financial provision to cover present and post-war conditions. We are alarmed over the situation. We are frankly wondering what is to become of the company . . .
>
> It is hardly necessary to add that this is not a plea for war profits. It is written to emphasize the fact that we must have money left after paying expenses (and taxes in any form are expenses), if we are to keep the factory doors open and do the job that must be done twenty-four hours a day.

One reason for such expressions of concern, which is not generally understood by the public but is of critical importance when proposed tax rates go as high as 90 per cent on earnings above an arbitrarily designated base, is the difficulty of determining income during the war. It is a commonplace of accounting that "net income" at any time is only an estimate, and this is true now more than ever.

In particular, the question of what provision the corporations should make for the special costs and hazards of war and post-war adjustments,—and, equally important, what deductions from income the Treasury should allow,—is a major problem. If the reserves and deductions allowed are inadequate, taxable "income" will overstate the true earnings. The danger is one of taxing normal profits excessively, and taxing away "excess profits" almost completely, at a time when the determination of profits is extraordinarily difficult, and when tax regulations do not admit many elements of cost which war earnings should bear.

Types of Special Reserves

The Committee on Accounting Procedure, American Institute of Accountants, issued in January 1942 a bulletin entitled "Accounting for Special Reserves Arising Out of the War," which listed the following purposes for which special reserves may be desirable:

(1) Accelerated depreciation of facilities as a result of intensive use and of operation by less experienced personnel.

(2) Accelerated obsolescence of facilities due to intensive research during the war in an effort to increase productive efficiency.

(3) Amortization of the cost of rearrangement and alteration of existing facilities which will probably be rearranged in the post-war period.

(4) Amortization of the cost of additional facilities acquired, the usefulness of which is expected to be substantially reduced at the termination of the war.

(5) Losses which may be sustained at the end of the war in the disposal of inventories useful only for war purposes, or in the adjustment of purchase commitments then open, including any amounts which may be paid for the cancellation of such commitments.

(6) Losses which may be sustained in the disposal of inventories not necessarily applicable to war production, due to decline in the price level, which, on the basis of past experience, usually follows a pronounced rise in prices.

(7) Repairs and maintenance deferred as a result of pressure for war production.

(8) Restoration or alteration of facilities to peacetime production at the end of the war, if it is reasonable to assume that such restoration or alteration will then be made.

(9) Separation allowances which may be paid to employees who are discharged at the termination of the war.

(10) Losses from destruction of property as a result of the action of armed forces or from seizure thereof by the enemy.

(11) Decline in the useful value of plant and equipment due to excess capacity resulting from war construction.

Without attempting to discuss these proposals in detail, it is clear that while some are of the "must" type and others of the "may" type, all merit serious consideration. For example, there is no question as to the need for accelerated depreciation of equipment when it is being run practically 24 hours per day, frequently overloaded beyond the capacity for which originally designed, and operated by less experienced personnel.

Unfortunately for the corporations, most of the reserves proposed as desirable are not recognized by the Treasury as allowable deductions from income in computing taxes; or (such as accelerated depreciation) are admitted only in part. It has been a long-standing principle of the Bureau of Internal Revenue that only established and ascertainable losses can be deducted. The result is that corporations, even where they set up additional reserves on their own books for these special costs and hazards, must pay their taxes on an "income" which often permits little or no provision for them. When the anticipated loss is finally established a tax credit at the rates then in force will be admitted. Meanwhile, however, taxes will have been paid, in cash, at wartime rates.

At the same time, a tax rate which would leave to corporations only 55 per cent of their base earnings and only 10 per cent of earnings above the base, would as a rule prevent the accumulation of adequate reserves. Many corporations which at their own risk are multiplying output for the war effort will pay the excess profits rate on the bulk of their earnings. In too many cases, their cash will be paid out for taxes, and the "profits" on their books will

be represented by assets whose value may depreciate and largely disappear, almost overnight.

The Public Interest

This danger concerns the whole economic organization. Although the principle that no unjust enrichment should result from the war justifies the levying of abnormally high taxes upon abnormal earnings, other principles are also involved. One is that expansion of war production should not be hampered by taxation so heavy that the producer stands more chance of loss than of gain when the books are finally closed. Another is that the ability of corporations to meet post-war adjustments, including the abnormal write-downs to be expected as well as the cost of reconverting to peacetime operations, should be preserved. Manufacturers of standard machine tools, as one example, may find their market saturated after the war, and will need reserves represented by liquid assets to carry them through the readjustment period. The automobile industry will have to reconvert before it can give employment again.

The basic consideration of all is that both the war effort and post-war progress depend upon the solvency and vitality of the industrial system.

Reserves Against Inventories

One of the problems of chief concern is the rise in inventory values. Although total inventories of all manufacturing corporations, amounting to $11 billions at the end of 1939, were but one-fifth of their total assets, changes in inventories are normally a major factor determining profit or loss. Statistics collected by the Department of Commerce indicate that from December 1939 to May 1942 the dollar value of manufacturers' inventories rose 59 per cent to a new all-time high. In such times earnings computed by the method of valuing inventories at "cost or market whichever is lower" tend to include profits locked up in higher-priced inventories. In the inevitable post-war adjustments the apparent "profits" may be wiped out, despite the fact that heavy income and excess profits taxes have been paid on them in the meantime.

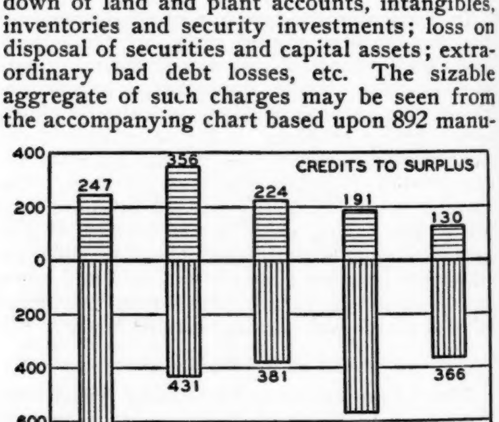
In order to eliminate or at least minimize the effect of price fluctuations upon inventory valuations and earnings, many companies have turned to the "last-in, first-out" basis, referred to as "LIFO." This method has been acceptable for tax purposes since the Revenue Act of 1939, subject to the approval and regulations of the Commissioner of Internal Revenue. Other companies have chosen to accomplish the same ends by setting up inventory reserves. While the latter method of adjustment is somewhat more flexible, such reserves are not now allowable deductions from income in computing taxes.

In the Ways and Means Committee hearings on the revenue bill, Mr. Randolph Paul, spokesman for the Treasury Department, proposed that inventory reserves should be made admissible for tax purposes. It was suggested that taxpayers be permitted to set up reserves for the period beginning January 1, 1941, and ending five years after the close of the war, such reserves to comprise the approximate inventory profit. Since reserves would have to be fully closed out and accounted for within the time specified, they would not permit profits from a permanent rise in values to escape taxation, but would prevent in substantial measure the current taxation of inventory profits destined to be wiped out in the next few years. The proposal is not incorporated in the tax bill as passed by the House, but it is hoped that the Senate will adopt it.

The Disappearance of Capital

It is often charged that corporate reserves are set at excessive figures for the purpose of concealing earnings; but on the contrary there is evidence that earnings over a period generally have been overstated. Even in peacetime, aggregate annual reserves set aside by corporations have not proved adequate to cover all losses and expenses, and over past years there has occurred a substantial "disappearance" of industrial capital.

A channel through which considerable of this disappearance takes place is the "surplus adjustment," by which various charges are made directly against surplus account instead of against income. Such charges include write-down of land and plant accounts, intangibles, inventories and security investments; loss on disposal of securities and capital assets; extraordinary bad debt losses, etc. The sizable aggregate of such charges may be seen from the accompanying chart based upon 892 manu-



Surplus Adjustments of 892 Manufacturing Corporations Registered with the S.E.C.
(In Millions of Dollars)

facturing corporations registered with the Securities & Exchange Commission and covering the years 1935-1939. For the five-year period,

total debits to surplus aggregated $2,531 millions. In the same period, total credits to surplus (exclusive of additions from net income, or additions from reducing the par or stated value of capital stock) aggregated $1,148 millions. The excess of surplus debits, therefore, amounted to $1,383 millions, which was one-seventh of the reported net income.

These charges against surplus do not imply that the specific reserves set up each year against plant, inventory, receivables, etc., were inadequate at the time, but rather indicate the uncertainty and difficulty in estimating the full reserves that may be needed. Even 'ndustries with the most favorable records, and the best individual companies, are not immune to unusual losses; and industrial capital in many cases has relatively short life because of continual change in machinery, methods, demand, markets, styles and other factors.

Write-Downs in Reorganization

Still heavier writing-down of assets and capital funds is encountered in reorganizations and liquidations. This—like the surplus charge—is not reflected in the income account, yet indicates a similar and even more rapid "disappearance" of capital. A study of experience after the last war is revealing as to the hazards now existing. Many corporations whose expansion of production helped win the war found themselves worse off at the end than at the beginning, despite their presumed profits, and in the few years after the war bankruptcies and reorganizations of large manufacturing corporations, prominent at that time, were numerous.

Following is a summary covering 65 corporations in various manufacturing industries which were forced to reorganize during the 1920s, showing the combined assets reported on the last balance sheet published before reorganization, and on the first after reorganization:

Total Assets Reported by 65 Manufacturing Corporations Before and After Reorganization in the 1920s.

Assets before reorganization	$2,558,929,000
Assets after reorganization	1,269,608,000
Change	—1,289,321,000
% change	— 50%

This group comprises companies representing the following industrial groups: food products, beverages, tobacco, textiles, leather, paper, chemicals, petroleum, iron and steel, machinery and equipment, autos and parts, shipbuilding, and miscellaneous manufacturing.

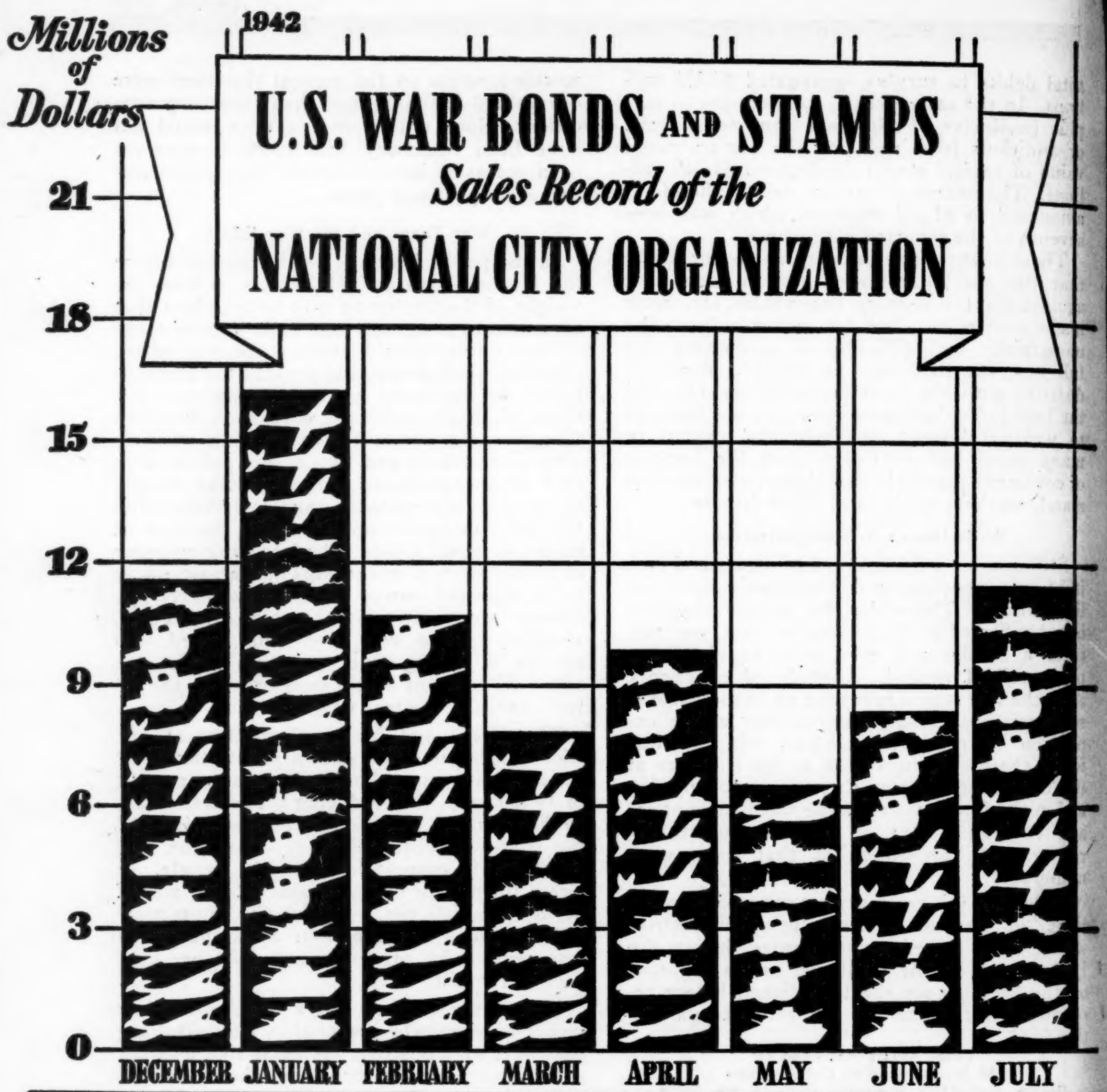
These companies reported total assets before reorganization ranging from $5 millions upwards. Some of the reorganizations involved receivership and court proceedings, while others represented voluntary agreement between creditors and shareholders, or merely recapitalization. For the group as a whole, the decrease in assets aggregated $1,289 millions or 50 per cent. Most of this decrease represented the writing-down of various fixed and working assets on the ground that they were overvalued in the light of then prevailing conditions. Such drastic write-downs would not have been necessary had adequate reserves been set aside out of income during the war and early post-war years.

War Taxes and the War Effort

In the public hearings on the tax bill before the House Ways and Means Committee, the weight of the testimony was to the effect that attempts to recapture too high a percentage of war profits would hamper the war effort, stimulate inefficiency, and prevent the accumulation of necessary post-war reserves. Mr. Colin M. Stam, principal advisor to the joint Congressional committee on taxation, was one who so testified; and two of his points were that allowance must be made for the margin of error in determining taxable income, and that such income is not always in the form of money or liquid assets. The foregoing evidence of over-statement in earnings in the past, likely to be repeated during this war, supports Mr. Stam's argument. Mr. Donald M. Nelson, speaking for the War Production Board, was specific in saying that an excess profits tax above 80 per cent would interfere with the effectiveness of the war program.

The Ways and Means Committee at one time decided upon an excess profits tax of 94 per cent but proposed to allow a post-war credit of 14 per cent, thus reducing the effective rate to 80 per cent. The Committee itself dropped the post-war credit before reporting the bill; but there is support for it in the Senate. In Great Britain the excess profits rate for a brief period was 100 per cent, but the impracticability of such a tax became apparent and it was revised by provision for a 20 per cent post-war credit.

The argument for fixing a rate higher than would otherwise be practicable, and offsetting part of it by a post-war credit, is that a larger part of corporation income is thereby channelled temporarily to the Treasury, while at the same time a reserve for post-war use is provided. This is admittedly a strong argument. On the other hand, leaving funds with corporations does not preclude their use by the Treasury through regular borrowing, if the corporation is sufficiently liquid. Second, if tax payments reduce working capital for war production the promise of refunds does not restore it. Third, the refunds would be spread over a period of years, with reference to the convenience of the Treasury rather than to the precise post-war needs of the corporation. In order of desirability, the post-war credit ranks much above an excessive tax rate without any offset, but clearly stands second to the fixing of the rate itself at an equitable and practicable figure.



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